THE GENERATIONS FUND

Shaping the Québec of tomorrow today

Québec

TACKLING THE DEBT

Québec's debt stands at $118 billion, which represents close to 43% of our economy and almost double the Canadian average.

Firmly resolved not to leave future generations with the heavy burden of repaying the public debt, the government's aim is to reduce the debt below 25% of GDP by 2025, i.e. the current average of the Canadian provinces.

Currently, the government pays over $7 billion in interest on Québec's debt, making it the third-largest expenditure item after health and education.

Our bugetary discipline has enabled us to make great strides in restoring order to public finances. We can now take up the challange of reducing the debt burden with even more determination.

MOST FREQUENTLY ASKED QUESTIONS ABOUT THE GENERATIONS FUND

1. What is the purpose of the Generations Fund?

The Generations Fund will be devoted exclusively to reducing the debt. A law to this effect will be presented to the National Assembly.

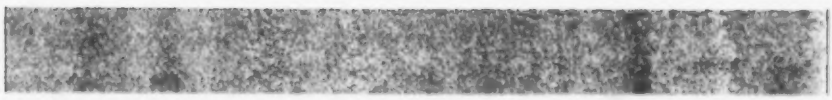
2. How will the Generations Fund be financed?

To finance the Generations Fund, the government will tap into our largest collective renewable resource: water.

The Generations Fund will have five main revenue sources:

- water-power royalties Hydro-Québec will pay beginning in January 2007;
- water-power royalties already collected by the government from private producers of hydro-electricity;
- a portion of the profits Hydro-Québec will earn from foreign sales of surplus electricity production;
- a royalty on water harnessed in Québec;
- non-strategic asset sales.

In short, no new taxes will be levied to finance the debt reduction.



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[redacted]

3. Why reduce the debt?

Individuals, society as a whole and Québec's economy are suffering the harmful effects of the government's heavy debt load. The need to act is urgent, above all, to improve equity toward future generations, but also to be better prepared for the demographic shock and ensure continued funding for Quebecers' priorities.

4. Who will manage the Generations Fund?

The government will entrust the Caisse de dépôt et placement du Québec with the responsibility of growing the assets of the Generations Fund, which will accelerate repayment of the debt.

5. What impact will the Generations Fund have on the reduction of Québec's debt?

The creation of the Generations Fund will reduce the debt burden from 43% to 25% of GDP by 2025. In 2025, close to $30 billion will go toward repaying the debt.

[redacted]

ASSUMING OUR RESPONSIBILITIES

With the creation of the Generations Fund, the government is taking another step in restoring order to its public finances and improving equity toward future generations. This unprecedented initiative is indicative of the government's determination to preserve, for the future, the level and quality of the public services Quebecers value so highly.

Acting now to preserve public services

ASSUMING OUR RESPONSIBILITIES

With the creation of the Generations Fund, the government is taking another step in restoring order to its public finances and improving equity toward future generations. This unprecedented initiative is indicative of the government's determination to preserve, for the future, the level and quality of the public services Quebecers value so highly.

Acting now to preserve public services

Projection of amounts accumulated in the Generations Fund

"The Generations Fund is an appeal
for true solidarity with future generations."

– Michel Audet, Minister of Finance
March 23, 2006

Finances
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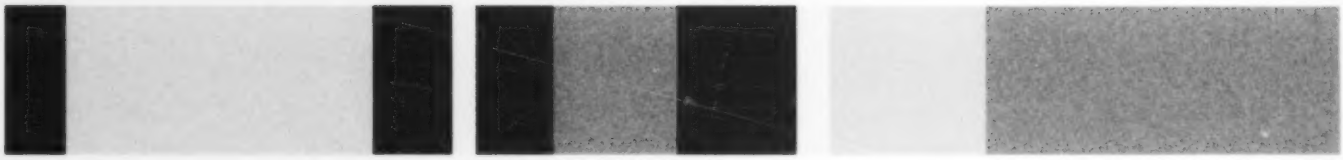
The Generations **Fund**

To foster inter-generational equity, sustainable social programs and prosperity

Québec



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To foster inter-generational equity, sustainable social programs and prosperity

Finances Québec

The Generations Fund
To foster inter-generational equity,
sustainable social programs and prosperity

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The Generations Fund

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Summary

The debt: a major problem

Québec has a very large debt. By March 31, 2006, it is expected to amount to $118.2 billion, i.e. $15 551 for every man, woman and child in Québec.

The size of the debt can truly be judged when Québec's situation is compared with that of other jurisdictions. Québec is the most indebted province in Canada with a debt-to-GDP ratio of 42.7%.

To a certain degree, Québec's heavy debt load could be justified if it had been used essentially to finance capital expenditures or profitable investments in government corporations with an economic mission. Future generations would then have enjoyed substantial benefits in return for this debt.

But that is not the case. More than three quarters of Québec's debt, i.e. $90.7 billion, has been accumulated over the last 30 years to fund current spending. As a result, there now remains a large debt that future generations will have to repay while receiving few benefits in return.

The importance of acting now

It is important to begin reducing the debt burden now. More than anything else, that will help improve equity toward future generations.

It will also help reduce debt service and, in this way, generate leeway to ensure sustainable funding for social programs. That is particularly important in view of the negative repercussions that slower population growth and the aging of the population will have on Québec's economy and public finances.

Reducing the debt burden will also make public finances less sensitive to rising interest rates. It is important to emphasize that the low interest rates of recent years have substantially limited the harmful effects of the growth in Québec's debt.

Lastly, reducing the debt will contribute to increasing investment and will create a favourable environment for economic growth and a rising standard of living for Quebecers.

To achieve these results, the government must take concrete steps right away. Progress in reducing the debt will take time. To expect to eliminate in just a few years a debt that has been accumulated over more than three decades is unrealistic.

The Generations Fund

In this context, the government has decided to set a demanding target: reduce the burden of debt in the economy to 25% by 2025, i.e. the current average of the Canadian provinces.

To achieve this target, the government is setting up the Generations Fund. This fund will be created by law and the monies paid into it will be managed by the Caisse de dépôt et placement du Québec.

This approach will ensure that the Generations Fund remains a permanent tool to be used to reduce the debt burden. The amounts accumulated in the Generations Fund may not be used for any purpose other than debt repayment.

Using existing taxes to build up the Generations Fund was out of the question. That would have compromised the funding of public services.

Accordingly, the Generations Fund will have five revenue sources, with the result that existing taxes will not be raised, thus limiting the harmful impact on the competitiveness of Québec's tax system. These five revenue sources are:

— water-power royalties Hydro-Québec will gradually pay beginning in January 2007;

— water-power royalties already collected by the government from private producers of hydro-electricity;

— a portion of the profits Hydro-Québec will earn from foreign sales of electricity from new production capacities;

— asset sales;

— a royalty on water harnessed in Québec.

The last three revenue sources will be studied in detail before being implemented.

Lastly, the government reserves the option, based on how the situation evolves, to allocate other sources of revenue to the Generations Fund.

Concrete results

Thanks to the Generations Fund, Québec is making an important and unprecedented effort to retire the debt. Achieving the objective of 25% of GDP by 2025 will have tangible positive effects on Québec's public finances and economy.

First, it will enable the elimination of one third of the debt accumulated to fund current spending.

Next, the Generations Fund will increase the government's leeway. By 2015, when the effects of the aging of the population begin to be felt, annual savings on debt service of more than $500 million will be achieved.

Lastly, debt repayment will create a favourable environment for improved economic growth, a higher standard of living and an upgrade in Québec's credit rating on financial markets.

Introduction

Restoring order to public finances: meeting the challenge

For almost three years now, the Québec government has imposed rigorous budgetary discipline. The budget has been kept balanced because spending has been managed stringently.

TABLE 1

PROGRAM SPENDING GROWTH FROM 2003-2004 TO 2005-2006
(Annual average, per cent)

Federal government	All provinces	Québec
7.0	6.4	3.7

Source: Ministère des Finances.

This discipline has kept the focus on Quebecers' priorities, namely health care, education, family and culture. For example, $4.2 billion has been invested in health care alone since 2003-2004.

At the same time, the personal tax burden, particularly for families, has been cut by $2.9 billion. The tax burden disparity with the Canadian average has been reduced by more than half and Québec's economy has been reinvigorated despite the difficult international context.

Although the budgetary situation has been, and still remains, challenging, Québec is now on a new road to development and prosperity.

A new challenge: reducing the debt burden

However, Québec must now face another major challenge, i.e. reducing the burden of its public debt.

The Generations Forum, assembled at the initiative of the Premier in the fall of 2004, shed light on the problems raised by a heavy burden of public debt vis-à-vis the aging and expected slower growth of Québec's population. This dynamic threatens inter-generational equity, public finances and economic prosperity.

To curb this dynamic, the 2005-2006 Budget Speech announced that the government intended to reduce the debt burden to less than 40% of GDP by the end of the decade.

During the pre-budget consultations last January and February, many participants insisted on the urgent need to act to reduce the debt burden and proposed ways to do so. A broad consensus emerged around this objective.

The Québec government is also convinced that a process to reduce the public debt must be undertaken. The creation of the Generations Fund marks a new stage in this process.

The National Assembly will be called upon to pass legislation creating the Generations Fund. The legislation will provide Quebecers with the assurance that the efforts made will be sustainable and will determine the resources allocated to debt retirement, which thus will become an irreversible process.

Québec's public debt: current situation

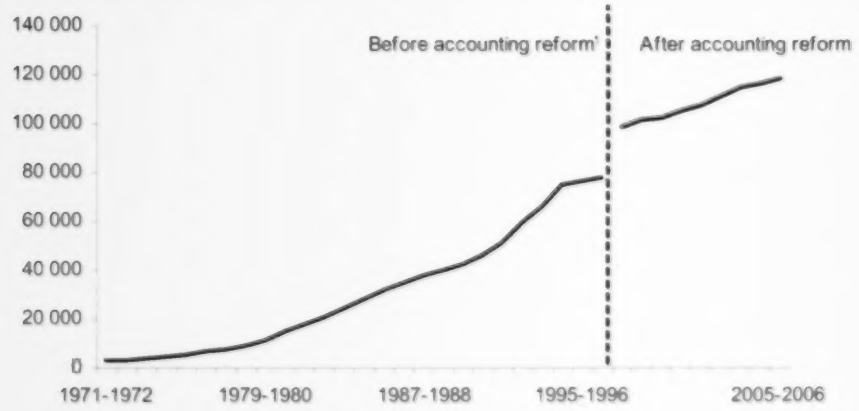
Before describing the Generations Fund, it is important to clearly set out the situation of the Québec government's debt, the causes of its significant growth in recent decades and the reasons that are now prompting the government to made debt retirement a priority.

A bloated debt

As at March 31, 2006, the Québec government's total debt will reach $118.2 billion, i.e. $15 551 for each Quebecer. Québec's debt has increased substantially over the last 30 years. The debt was small in the early 1970s. As at March 31, 1972, for instance, it amounted to only $2.9 billion.

CHART 1

THE QUÉBEC GOVERNMENT'S TOTAL DEBT
(Millions of dollars)



1 The accounting reform announced in the 1998-1999 Budget Speech entailed a $17.7-billion increase in the total debt in 1997-1998 attributable to the inclusion of the entire liability under the retirement plans and a broadening of the reporting entity. It was not possible to restate data for prior years.

Source: Ministère des Finances.

Debt concepts used

The **total debt** is the concept featured in the budget papers and debt service payments are applied to this debt.

The larger the total debt, the greater the level of debt service. In 2005-2006, debt service amounted to $7.5 billion, the third largest spending item after health and education. Accordingly, the greater the budgetary space occupied by debt service, the fewer the resources left for public services and the more vulnerable are public finances to a rise in interest rates.

Other debt concepts are used in government accounting, in particular net debt and debt representing accumulated deficits.

Net debt corresponds to the difference between the government's liabilities and its financial assets. Financial assets include in particular capital outlays in government corporations, earnings not paid as dividends by such corporations and loans made to third parties. Other liabilities include accounts payable and amounts borrowed to fund network and municipal infrastructures.

The government's net debt consists of the **debt representing accumulated deficits** and the non-amortized balance of fixed assets.

TABLE 2

DEBT CONCEPTS
(As at March 31, 2006, millions of dollars)

Government's total debt	**118 159**
Less: financial assets net of other liabilities	14 372
Net debt	**103 787**
Less: non-amortized balance of fixed assets	13 065
Debt representing accumulated deficits	**90 722**

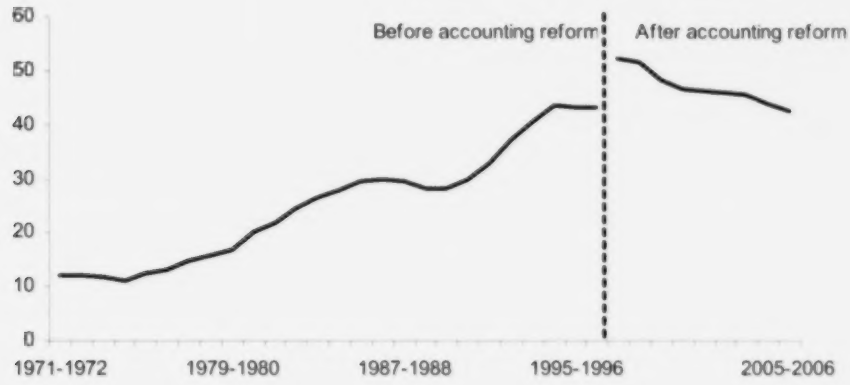
Source: Ministère des Finances.

Regardless of the concept used (total debt, net debt or debt representing accumulated deficits), the conclusion is the same: Québec is one of the most debt-ridden provinces in Canada.

Despite the progress achieved since balancing the budget in 1998-1999, the relative weight of the debt in the economy remains very heavy. Québec's debt stood at 52.2% of GDP as at March 31, 1998. As at March 31, 2006, this ratio will still be 42.7%. As at March 31, 1972, the debt represented only 11.9% of GDP.

CHART 2

QUÉBEC'S DEBT BURDEN
(As a percentage of GDP)

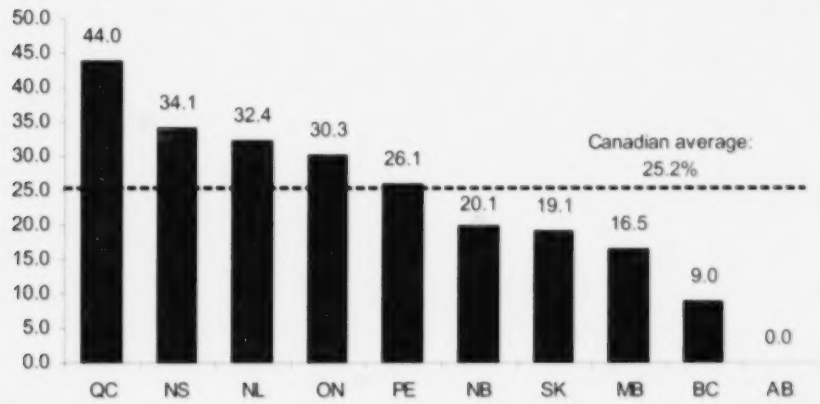


Source: Ministère des Finances.

In addition, the Québec government's debt as a proportion of GDP is currently the highest among the provinces of Canada, at almost double the provincial average.

CHART 3

COMPARISON OF PROVINCIAL INDEBTEDNESS AS AT MARCH 31 2005
(As a percentage of GDP)



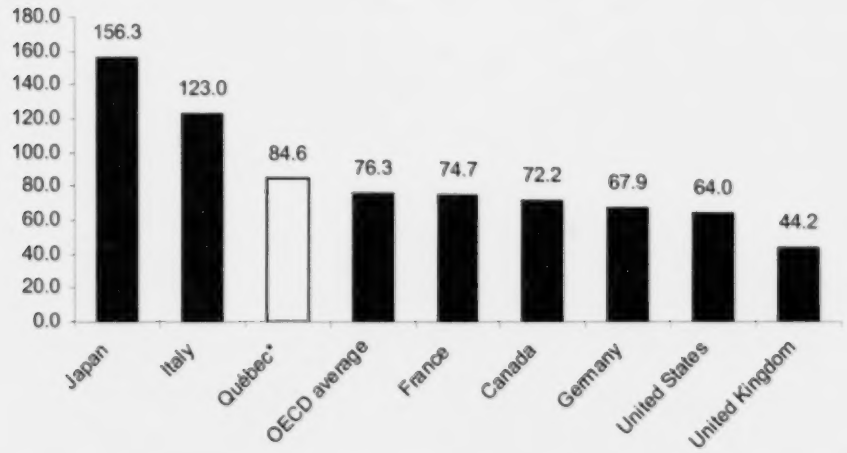
Sources: Provincial budgetary plans and public accounts – 2005-2006.

Québec also figures among the most heavily indebted states internationally. The debt of all public administrations in Québec is greater than that of most countries of the Organization for Economic Cooperation and Development (OECD). Among the G7 countries, only Italy and Japan have a higher debt ratio than Québec.

However, it is important to note that this comparison is shown for illustration purposes only since there are difficulties with comparisons of this kind, particularly because of significant differences in the definition of the government entity.

CHART 4

DEBT OF ALL PUBLIC ADMINISTRATIONS, QUÉBEC AND SELECTED OECD COUNTRIES, 2004
(As a percentage of GDP)



* Debt as at March 31, 2005.

Note: For the purposes of this analysis, Québec's debt excludes the liability of state employee retirement plans. However, it does include the debt of the municipalities, the education and health networks and a portion of the federal debt, excluding the liability of public sector employee pension plans, corresponding to Québec's demographic weight in Canada (23.6%).

Sources: OECD Economic Outlook, December 2005, Fiscal Reference Tables, Department of Finance Canada, October 2005 and 2006-2007 Budget Plan.

Debt accumulated to fund current spending and the interest on that debt

Debt can be justified when it is used to fund public services or investments that result in benefits over many years. For instance, infrastructure expenditures (roads, buildings, etc.) provide benefits for the public that extend over the useful life of such facilities. The same is true of capital outlays in certain government corporations that are used to fund productive investments, in particular Hydro-Québec dams. These capital outlays contribute to the development of these enterprises and therefore to economic growth, to the benefit of society as a whole.

Debt allows the funding of certain activities to be spread over many years and match their benefits and their funding over time. Consequently, this approach is desirable from the standpoint of inter-generational equity.

On the other hand, using debt to fund current spending is not fair to future taxpayers who will bear the financial charges of services from which they will have enjoyed little benefit.

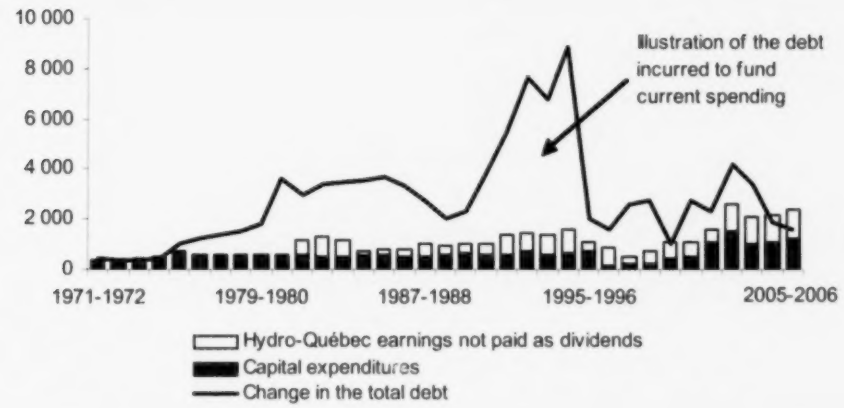
Moreover, faced with a significant temporary slowdown in economic activity and falling tax receipts, the government can run deficits and increase its debt to avoid having to temporarily reduce the level of public services. In this case, the increase in the debt should be short-lived, to the extent that it is desirable that once the economy recovers, the government posts surpluses and retires the accumulated debt.

This approach is reflected in the *Balanced Budget Act* around whose principles there is broad consensus in Québec society.

The result of the above is that the large size of Québec's debt could, to a degree, be justified if the debt load of the last 30 years had been used essentially to fund fixed assets and profitable capital outlays in government corporations with an economic mission. However, upon examining the sources of the increase in the debt since the mid-1970s, it is clear that such has not been the case. The increase in the debt was used mainly to fund current spending.

CHART 5

INCREASE IN THE DEBT[1] AND GOVERNMENT INVESTMENTS
(Millions of dollars)



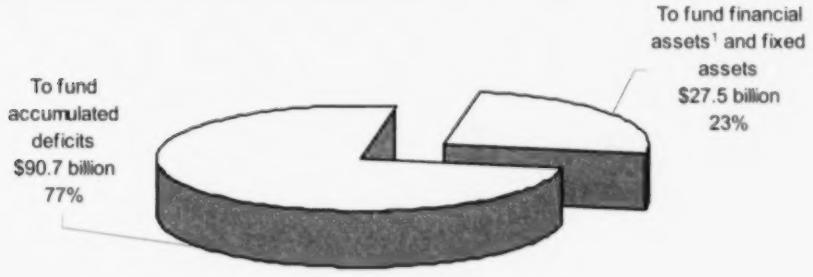
1 The increase in the debt does not reflect the effect of the accounting reform in 1997-1998.

Source: Ministère des Finances.

Today, the budget deficits incurred to fund current spending total $90.7 billion and account for more than three quarters of the government's total debt.

CHART 6

APPLICATION OF THE TOTAL DEBT OF $118.2 BILLION ACCUMULATED AS AT MARCH 31, 2006
(Billions of dollars)



1 Net of other liabilities.

Source: Ministère des Finances.

Consequently, less than one quarter of the Québec government's existing debt has been used to fund fixed assets or capital outlays in government enterprises, mainly Hydro-Québec. As at March 31, 2006, the Québec government's fixed assets will total $13.1 billion, while its participation in Hydro-Québec will reach $18.3 billion.[1]

A large and growing debt service

Moreover, the use of debt to fund current spending, together with high interest rates in recent decades, has helped to create a dynamic of debt, ever increasing debt service and deficits. As a result of this dynamic, debt service has gradually risen to $7.5 billion in 2005-2006.

However, this dynamic has consequences. To balance its budget, the Québec government must today collect revenue that is $7.5 billion more than its program spending. That money contributes nothing to fund public services.

TABLE 3

THE QUÉBEC GOVERNMENT'S OPERATING BALANCE AND DEBT SERVICE
(Millions of dollars)

	Budgetary revenue (1)	Program spending[1] (2)	Operating balance (3) = (1) + (2)	Debt service (4)	Budgetary balance (5) = (3) + (4)
1971-1972	4 403	– 4 548	– 145	– 210	– 355
1981-1982	17 742	– 18 413	– 671	– 1 950	– 2 621
1991-1992	34 467	– 34 102	365	– 4 666	– 4 301
2001-2002	50 011	– 43 678	6 333	– 7 261	– 928
2005-2006	59 175	– 51 651	7 524	– 7 524	0

1 Including expenditures of consolidated organizations and specified purpose accounts.

Source: Ministère des Finances.

1 Corresponds to the value of Hydro-Québec assets less the value of its liabilities as at March 31, 2006. Note that the government's debt rises by about $2.5 billion per year even though the budget is balanced. About $1.5 billion of this increase is attributable to capital expenditures, while $1 billion is due to the fact that the government allows Hydro-Québec to keep half of its earnings to fund its capital investments. That is equivalent to a capital outlay by the government in Hydro-Québec.

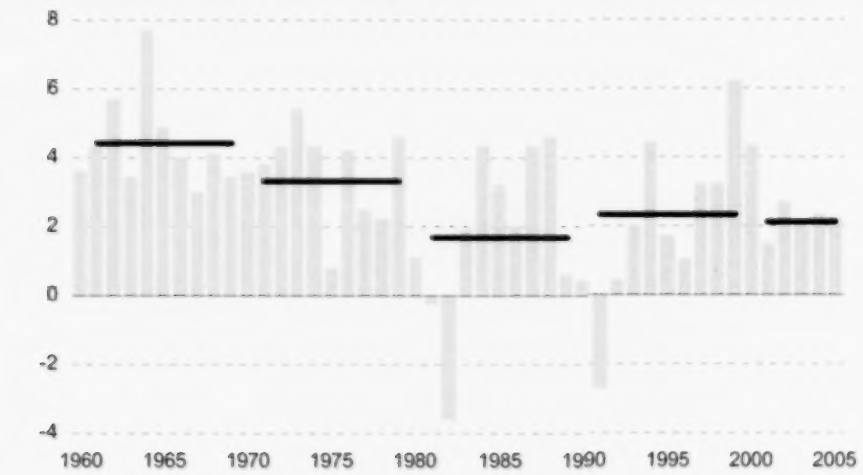
Deficits that were not offset during periods of economic recovery

Lastly, it is clear that the portion of the debt that was used to fund current spending was not applied to counter economic fluctuations. Québec has had two episodes of significantly slowing economic activity, the first in the early 1980s and the second in the early 1990s. These downturns were followed by economic recovery that was sufficiently robust to offset the budget deficits and debt incurred during the economic slowdown.

Deficits persisted and the debt rose in past years in particular because the growth of Québec's economy, like that of most North American economies, suffered a major structural slowdown. Average economic growth, which was 3.9% between 1960 and 1980, declined to 2% during the following two decades. It should be pointed out that one quarter of this slowdown is attributable to Québec's lower population growth.

CHART 7

ECONOMIC GROWTH IN QUÉBEC
(Real GDP, annual percentage change)



Note: The horizontal bars indicate averages per decade.
Source: Institut de la statistique du Québec.

The delay in recognizing the structural nature of this economic downturn and its impact on government revenues and expenditures contributed, among other things, to substantial budgetary deficits and a rising debt.

Reducing the debt burden: the urgent need to act

Individuals, society as a whole and Québec's economy are suffering the harmful effects of the government's heavy debt load. Today, reducing the debt burden has become a necessity.

The need to act is urgent, above all, to improve equity toward future generations, but also to be better prepared for the demographic shock and ensure continued funding for Quebecers' priorities. Action is also urgently needed to improve economic growth and prosperity.

Less effort will be required if we take steps to act now. The longer we put off the bold decisions that must be made, the greater the shock that future generations will have to deal with.

Improving equity toward future generations

The state has spent, without having sufficient financial resources, $90.7 billion over 30 years to fund services Quebecers have enjoyed in the past. The consequence is that there remains today a debt that coming generations will have to pay.

Beginning to retire the debt used to pay for current spending will help improve equity toward future generations and protect Québec's capacity to maintain, in the years ahead, the level and quality of public services. That means an additional effort by this generation, before it leaves the labour market, for the benefit of coming generations of Quebecers.

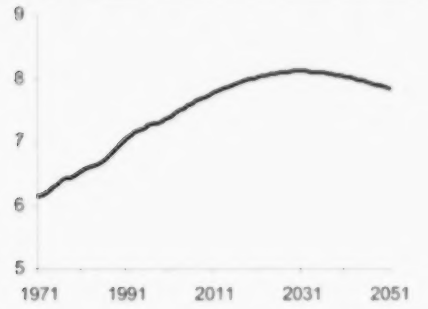
Facing the demographic shock

It is imperative to begin retiring the debt if Québec is to be better prepared to face the negative consequences that the aging of the population and its slowing growth could have on public finances.

Projections by the Institut de la statistique du Québec (ISQ) show that Québec's population growth is expected to continue to slow gradually over the coming years. The population is even forecast to begin declining in 2032. In 2050, Québec's population is projected to be 7.9 million, i.e. roughly the same as today.

CHART 8

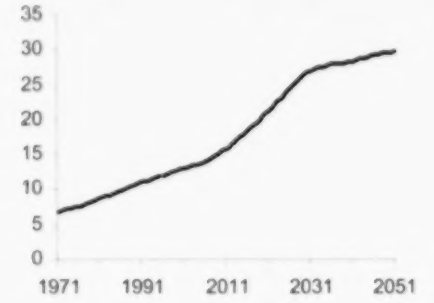
TOTAL POPULATION
(Millions)



Source: Institut de la statistique du Québec.

CHART 9

PERSONS AGE 65 OR OVER
(As a proportion of the total population)



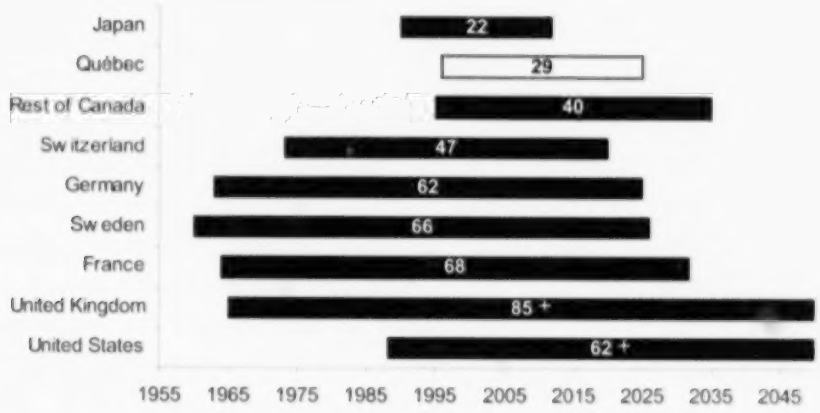
Source: Institut de la statistique du Québec.

Moreover, ISQ projections show that Québec's population will age significantly. The share of those age 65 or over in Québec's total population is expected to rise from 14% in 2005 to 30% in 2050.

In addition, the aging of Québec's population will be particularly rapid compared to most industrialized countries. The proportion of Québec's population age 65 or over will rise from 12% to 24% in only 29 years. Among the industrialized countries, only Japan's population will age at a faster rate.

CHART 10

NUMBER OF YEARS FOR THE PROPORTION OF PERSONS AGE 65 OR OVER TO RISE FROM 12% TO 24%
(Years)



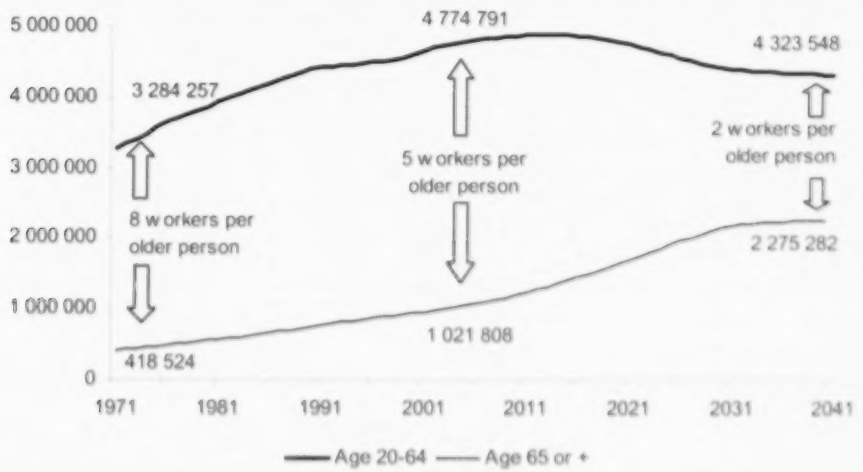
Sources: Institut de la statistique du Québec and United Nations.

Major budgetary consequences

Because of these expected demographic changes, economic growth and the funding of public services will be supported by a smaller proportion of the population since the number of workers per older person will fall from five to two within 25 years.

CHART 11

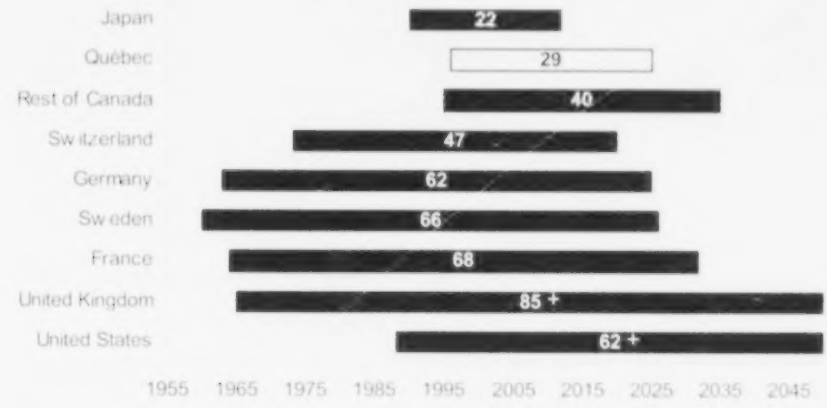
NUMBER OF WORKERS PER OLDER PERSON



Source: Institut de la statistique du Québec.

CHART 10

NUMBER OF YEARS FOR THE PROPORTION OF PERSONS AGE 65 OR OVER TO RISE FROM 12% TO 24%
(Years)



Sources: Institut de la statistique du Québec and United Nations.

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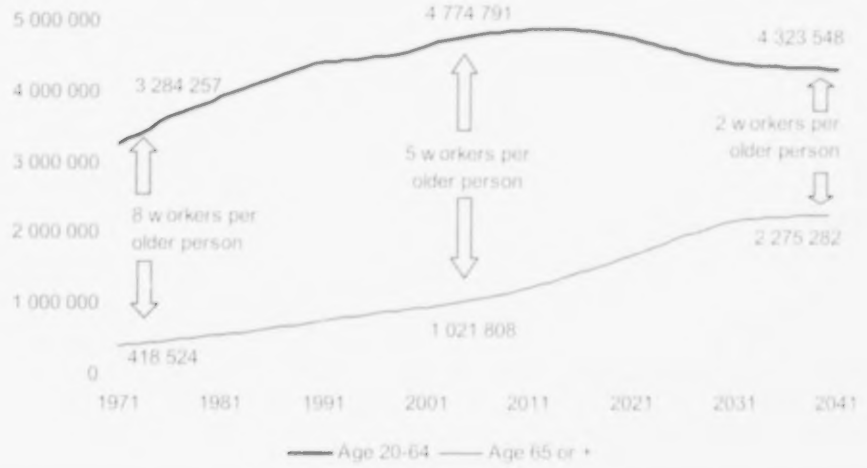


Source: Institut de la statistique du Québec.

In this context, real economic growth is expected to fall substantially within 20 years, resulting in slowing growth in government revenues.

This process has already begun. For many years now, Québec's lower population growth has had a direct effect on economic growth and that of government revenues. To illustrate, over the last decade, the disparity between Québec's economic growth and that of Canada was almost entirely attributable to Québec's lower population growth.

However, Québec has so far succeeded in maintaining its standard of living, as measured by per capita GDP.

TABLE 4

SOURCES OF ECONOMIC GROWTH, 1995-2004
(Per cent)

	Canada	Québec	
Per capita GDP	2.3	2.3	Equivalent growth in per capita wealth
Population	1.0	0.5	Lower demographic growth in Québec
Economic growth	3.3	2.8	Overall, Québec's GDP is growing more slowly

Source: Ministère des Finances.

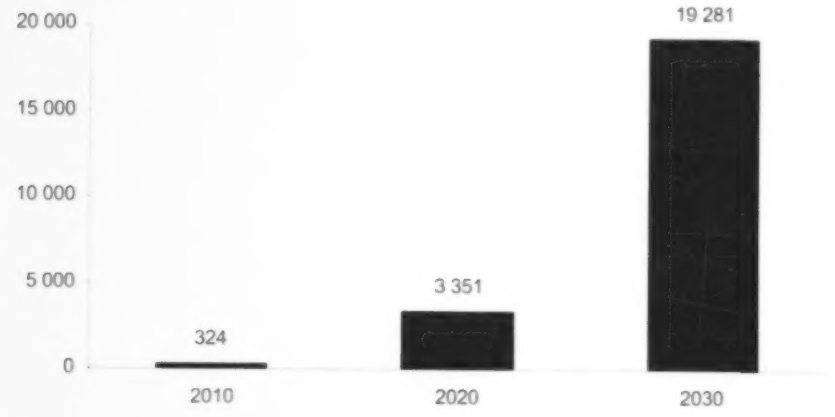
The aging of the population will also have important effects on growth in the Québec government's spending. Spending on health care and social services will come under significant pressure because the consumption of these services rises with age, not to mention of the costs associated with the use of new technologies. Accordingly, spending on health care and social services is expected to rise at an annual rate in excess of 5% over the next 25 years.

If these trends hold, and given the importance of health care spending in relation to all program spending, enormous pressure would be exerted on the government's financial framework, and therefore on financing of the other missions of government, such as education, environmental protection, public security, and economic and cultural development.

In this regard, a projection of the government's revenue and expenditure, taking expected demographic trends into account, shows that, if nothing is done, major and increasing budgetary efforts will have to be made to keep the budget balanced. That would mean spending cuts or an increase in the tax burden estimated at more than $3.3 billion in 2020 and more than $19 billion in 2030.

CHART 12

EFFORT NEEDED TO MAINTAIN A BALANCED BUDGET BASED ON CURRENT TRENDS
(Millions of dollars)



Source: Ministère des Finances.

Although these are only projections, the demographic trends seem so deep-seated that their possible impact cannot be ignored.

An insufficient improvement in the financial situation of retirees

Moreover, some maintain that the effects of demographic changes will be offset by the fact that older persons will be better prepared financially for retirement.

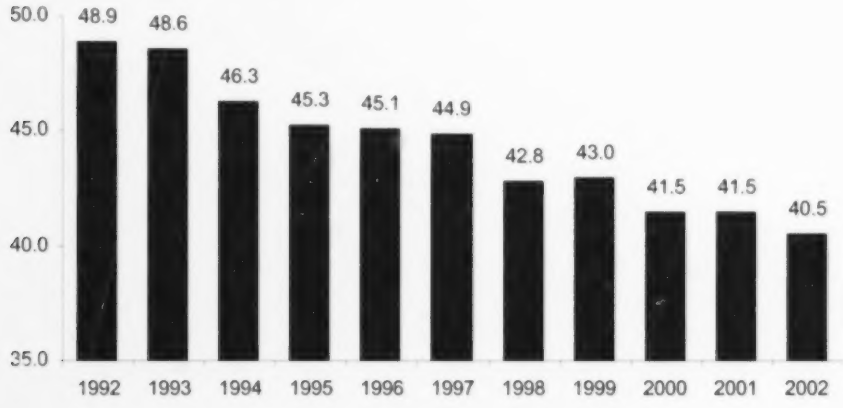
It is clear that newly retired Quebecers are better prepared for retirement than their parents, especially because of the growth in retirement savings accumulated by means of private group and individual pension plans. According to a recent study by the Régie des rentes du Québec, the average income of persons age 65 or over grew by 28%, in real terms, between 1981 and 2001.

However, again according to the Régie des rentes du Québec, the average income of persons age 65 or over was only $20 558 in 2001. In fact, almost half (44%) of those in this age group have an individual income of less than $15 000 per year and almost 80% have an annual income of less than $25 000. Only 5% of this population has an annual income of $50 000 or more.

Looking further ahead, and according to a Statistics Canada survey, roughly one third of households will be unable to maintain their standard of living at retirement. This is attributable in particular to the low level of personal saving and the fact that only 40% of Québec workers are covered by a registered pension plan. Furthermore, this proportion has fallen over the last ten years.

CHART 13

PROPORTION OF QUÉBEC WORKERS COVERED BY A REGISTERED PENSION PLAN
(Per cent)



Source: Statistics Canada.

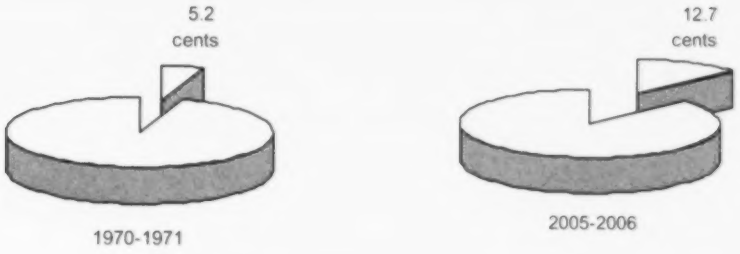
Consequently, although the financial situation of retirees is likely to continue to improve, this improvement will be insufficient to deal with the coming pressures on public finances, in particular those stemming from the funding of health care spending.

Restoring the government's financial flexibility

Today, debt service is the third largest spending item, after health care and education, amounting to $7.5 billion in 2005-2006, i.e. 12.7 ¢ for each dollar of budgetary revenue.

CHART 14

SHARE OF REVENUE ALLOCATED TO DEBT SERVICE
(Cents per dollar of revenue)



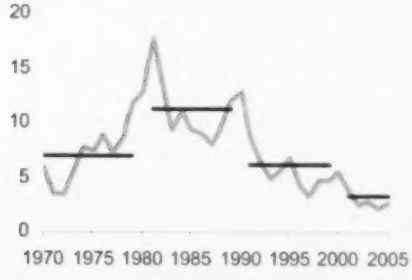
Source: Ministère des Finances.

As a result, the debt carries a significant risk of a deterioration in the government's financial position should interest rates rise. Each 1% increase in interest rates entails additional spending of about $300 million per year on debt service.

In recent years, interest rates have reached levels that historically are very low, which has allowed the Québec government to enjoy slower growth in debt service.

CHART 15

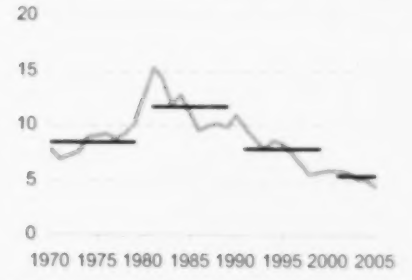
YIELD RATE OF 3-MONTH GOVERNMENT OF CANADA TREASURY BILLS
(Per cent)



Source: Ministère des Finances.

CHART 16

YIELD RATE OF 10-YEAR AND LONGER GOVERNMENT OF CANADA BONDS
(Per cent)



Source: Ministère des Finances.

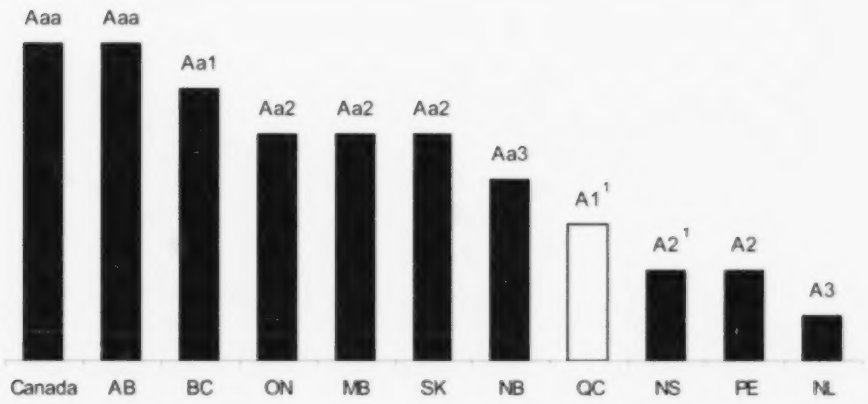
Nonetheless, should interest rates return, for a long period, to their average of the 1990s, the Québec government would face additional spending on debt service of roughly $1.1 billion per year. A return to the rates that prevailed in the 1980s would cause debt service to rise by $2.3 billion per year. That would increase pressure on the government's financial framework.

While experts do not forecast that interest rates to return to the levels of the 1980s or 1990s, caution is advisable. It is important to recall that in the 1960s or even the early 1970s, few experts had forecasted the high interest rates of the following decades.

Lastly, Québec's large debt has contributed to reducing its credit rating. Since 1981, the credit rating assigned to Québec by Moody's has fallen from Aa2 to A1. Québec's credit rating is among the lowest in Canada. Only Nova Scotia, Prince Edward Island and Newfoundland and Labrador have a lower credit rating than Québec.

CHART 17

CREDIT RATINGS ASSIGNED BY MOODY'S, 2005



1 Positive outlook.

Source: Moody's and Ministère des Finances.

In short, by reducing the debt burden, the government will improve its financial flexibility, which will enable it to maintain funding for the services Quebecers consider priorities and place it in a better position to deal with contingencies.

Improving economic growth and prosperity

Lastly, an excessive debt load contributes to reducing economic growth and the standard of living. The debt is funded from collective savings. Accordingly, the larger the debt, the less savings remain to fund job-creating investments.

Moreover, the possibility for Québec investors to obtain financing from savings held by foreigners does not avoid the problems relating to the debt load. While financing from abroad helps maintain the level of investment and economic growth, it entails the payment of interest and dividends to non-residents, which reduces the income of Québec society as a whole.

The existence of a large debt also entails a heavier tax burden since interest on the debt must be paid. This tax burden discourages savings, the supply of labour and investment by reducing returns on these activities. Accordingly, public expenditures are more costly than they appear when they are examined from an accounting standpoint: the taxation that funds them reduces the output of the economy as a whole.

Clearly, a large public debt, especially if it has been used to fund current spending, causes uncertainty as to the tax burden and public services in the future. This uncertainty can hamper the capacity to attract and retain companies and skilled workers. In an increasingly competitive international context, the stability of the economic and financial environment is unquestionably an important factor in site location decision-making and an engine of economic growth.

The Generations Fund: the most effective way to reduce the debt burden

The Québec government is committed to meeting the challenge of reducing the debt burden and to deploying the means to do so.

Meeting the challenge of reducing the debt burden

Many governments in Canada have already undertaken to reduce their debt burden.

In Québec, especially in recent months, many people and interest groups have indicated their growing concern regarding the size of the debt and its harmful consequences on Québec society as a whole.

The pre-budget consultations held by the Minister of Finance last January and February brought these concerns clearly to the fore and highlighted various approaches to reduce the debt burden. These proposals have added to the debate on this major issue.

The pre-budget consultations resulted in consensus on three major points:

- The *Balanced Budget Act* must be maintained to avoid borrowing to fund current spending ever again.
- The debt must be reduced in relation to Québec's collective wealth. Some maintain that the objective of 40% of GDP set in the 2005-2006 Budget is enough, while others argue that more should be done.
- Lastly, debt reduction must be framed in legislation to ensure that the approach will be sustained and the objectives achieved.

An examination of the proposals received during the recent pre-budget consultations as well as the approaches taken by a number of our neighbours can be used to define three major benchmarks for reducing the weight of Québec's debt.

Debt retirement: examples in Canada

Federal government

The federal government includes a contingency reserve of $3 billion per year in its fiscal plan as a precaution against economic changes. At the end of the fiscal year, funds from this reserve that have not been used are applied to debt retirement. Over the last eight years, the federal government has retired $63 billion of its debt, which stood at $499.9 billion as at March 31, 2005.

Nova Scotia

In June 2003, the government of Nova Scotia announced a plan to reduce the net debt by creating a specific debt elimination fund and passing legislation that allocates extraordinary revenues from asset sales to debt reduction.

In 2005, the government passed a new debt reduction plan following the agreement reached with the federal government concerning the special treatment of offshore oil revenues in the calculation of equalization. Under the new legislation, these amounts will be deposited in a special fund and may be used for no other purpose than retiring the government's debt.

Alberta

In 1995, the *Balanced Budget and Debt Retirement Act* was passed in Alberta. The act became effective in 1996-1997 and required the government to balance its annual budget and set out a plan to retire the total debt – excluding retirement plans liabilities – no later than 2021-2022. The debt retirement objective was achieved in 2000-2001 thanks to substantial oil revenues.

Manitoba

Since 1997-1998, under its debt retirement plan, the Manitoba government has transferred nearly $800 million to the Debt Sinking Fund. Beginning in 2005-2006, the Manitoba government intends to pay $110 million per year into this fund.

The target: reduce the debt burden to 25% of GDP by 2025

With a debt in excess of 42% of its GDP, Québec is the most debt-ridden province in Canada.

To correct this situation, the government has set an objective of reducing Québec's debt burden to 25% of GDP, thus reaching the current average of the provinces of Canada.

This demanding objective, which will require very substantial debt repayments, clearly cannot be achieved in the near future. The debt burden rose over a period of thirty years, hence a long-term plan is needed.

Accordingly, the government intends to adopt a pace of debt reduction that is compatible with taxpayers' ability to pay. Furthermore, in following this process, a balance must be found between debt retirement and continued adequate funding of public services.

That is why the government considers it reasonable that the target of 25% of GDP be achieved by 2025.

To guarantee results: set up a fund dedicated to debt retirement

Two broad approaches are available regarding debt retirement:

— Setting up, each year, a contingency reserve that would be allocated to debt retirement if the stipulated funds are not required during the year, for example, to deal with an economic downturn or uhforeseen expenditures.

— Creating a fund into which the government would pay, each year, dedicated revenues.

Setting up a reserve, in the current financial context, would mean that the Québec government would have to further reduce its spending or raise taxes. Neither of these options is realistic.

Moreover, using a reserve implies that debt reduction would come after the funding of needs that may arise during the year. Accordingly, the debt retirement would depend on potentially available budgetary funds and the result would be uncertain.

In this context, the government has decided to create a fund and to dedicate specific resources to it. Each year, monies will be allocated to debt retirement, providing Quebecers with assurance that continuous, measurable and systematic progress will be made in reducing the debt burden.

Accordingly, debt retirement will not depend on the availability of budgetary funds, but will proceed according to a known and predictable plan.

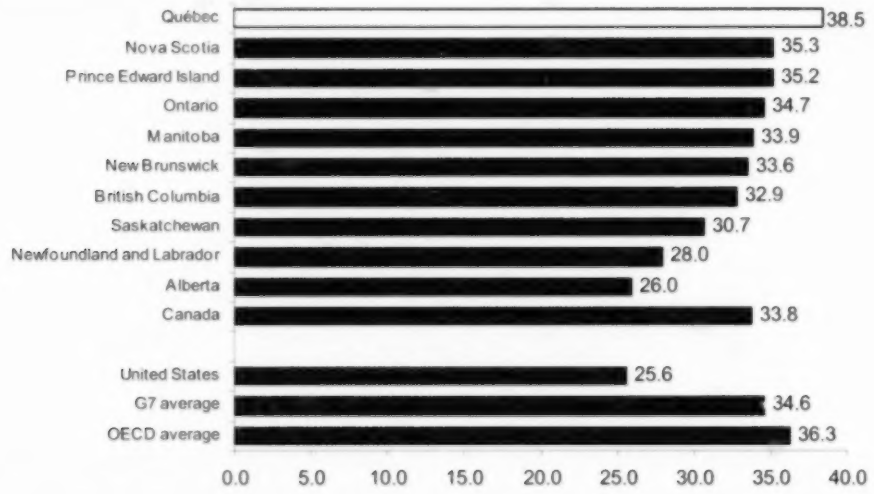
The method: allocate new revenue sources while minimizing the impact on Québec's tax competitiveness

The government intends to dedicate revenue sources that will have little impact on the competitiveness of Québec's economy to the Generations Fund.

The tax burden in Québec is currently the heaviest of all the provinces and among the heaviest within the OECD.

CHART 18

TAX RECEIPTS OF ALL PUBLIC ADMINISTRATIONS, 2003
(As a percentage of GDP)



Source: Ministère des Finances.

Consequently, raising personal and corporate taxes is not advisable. That would run counter to the recent measures designed, on the contrary, to continue reducing taxes, encouraging strong investment and creating more jobs.

Creation of the Generations Fund

A commitment written into law

The Generations Fund will be created by a law. This law will enshrine the fund as a permanent tool for reducing the debt burden. In addition, it will stipulate that the monies accumulated in the Generations Fund can be applied only to debt retirement.

The Generations Fund will be an entity separate from the Consolidated Revenue Fund, so that Quebecers can measure directly the extent of their efforts to retire the debt.

A fund managed by the Caisse de dépôt et placement du Québec

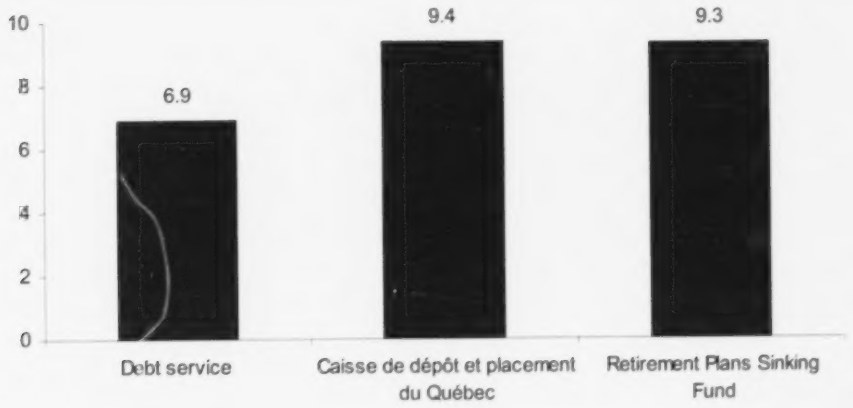
Moreover, the monies deposited in the Generations Fund will be managed by the Caisse de dépôt et placement du Québec (CDPQ), which will act as trustee. The government will instruct the CDPQ as to the appropriate investment policy to follow.

To maximize debt burden reduction, the dedicated revenues will not be used over the next few years to repay government borrowings. Rather, they will be accumulated in the Generations Fund to grow at a rate of return higher than that paid by the government on its borrowings. That will create leverage that will further accelerate debt burden reduction in the medium and long term. Once sufficient sums have been accumulated in the Generations Fund, the government can retire maturing borrowings.

Note that between 1995 and 2005, the CDPQ earned 9.4% on its total funds under management compared with an average cost of debt service of 6.9% for the government. The rate of return on amounts deposited in the public and parapublic sector employees Retirement Plans Sinking Fund (RPSF) and managed by the CDPQ was 9.3%.

CHART 19

COST OF DEBT SERVICE AND RATE OF RETURN OF THE CDPQ AND THE RPSF
(Average annual rate from 1995 to 2005, per cent)



Source: Caisse de dépôt et placement du Québec and Ministère des Finances.

Lastly, note that the amounts accumulated in the Generations Fund are an asset that will be accounted for as a reduction in the government's debt.

Sources of revenue allocated to the Generations Fund

Five sources of revenue will be allocated to the Generations Fund:

- water-power royalties Hydro-Québec will gradually pay beginning in January 2007;
- water-power royalties already collected by the government from private producers of hydro-electricity;
- a portion of Hydro-Québec's profits from foreign sales of electricity from new production capacities;
- asset sales;
- a royalty on water harnessed in Québec.

The last three revenue sources will be studied in detail before being implemented.

Moreover, the government reserves the option, based on how the situation evolves, to allocate other sources of revenue to the Generations Fund.

Water-power royalties from Hydro-Québec

The first source of funding the government has earmarked concerns water-power royalties. It is important to capitalize on Québec's water, an abundant renewable natural resource.

First, the government will impose the same royalties on Hydro-Québec as on private producers of hydro-electricity, i.e. the statutory and contractual royalties stipulated by the *Watercourses Act*.

These royalties will be imposed on Hydro-Québec gradually, over two years beginning January 1, 2007 to allow the government corporation time to adjust. Hydro-Québec will be invited to absorb the cost of the royalties chiefly through efficiency gains and by increasing export earnings. If necessary, the government is prepared to adjust expected earnings over time.

Watercourses Act

Under the *Watercourses Act*, private producers of hydro-electricity pay the government annual water-power royalties based mainly on the amount of electricity produced.

These royalties consist:

— of a **statutory royalty** of $2.66 per thousand kilowatt-hours of electricity produced; and

— a **contractual royalty** of $0.62 per thousand kilowatt-hour of electricity produced upon the awarding of water power by the state for the operation of a private generating station.

Hydro-Québec is currently exempt from paying these royalties. Had it been subject to them in 2006, they would have generated revenue of $500 million. Once they are applied to Hydro-Québec, these royalties will be indexed as is the case for private generating stations.

TABLE 5

APPLICATION OF WATER-POWER ROYALTIES TO HYDRO-QUÉBEC
(Millions of dollars)

Statutory royalty	400
Contractual royalty	100
Total	**500**

Source: Ministère des Finances.

Water-power royalties of private hydro-electricity producers

The government will pay the water-power royalties already collected from private hydro-electricity producers into the Generations Fund. Currently, these royalties amount to roughly $80 million per year. As of January 1, 2007, they will gradually be allocated to the Generations Fund.

Accordingly, beginning in 2008-2009, revenues of at least $600 million will be paid into the Generations Fund. These revenues are expected to rise with the increase in Hydro-Québec's production and the automatic indexing of royalties already stipulated by law.

Hydro-Québec's profits from foreign sales of electricity from new production capacities

Over the next few years, Hydro-Québec intends to continue developing Québec's hydro-electric potential. That will secure a source of clean, renewable and, compared to other energy sources, relatively inexpensive power for Quebecers for the coming decades.

Accordingly, the increase in Hydro-Québec's capacity will, over the next few years, make surplus production available for export. In view of the high price of electricity on export markets, this will enable Hydro-Québec to earn larger profits. The government will allocate part of these profits to the Generations Fund.

Asset sales

The government will also consider selling assets to finance the Generations Fund.

The government will undertake this examination in keeping with two clear principles:

— maintaining or improving public services;

— achieving a financial benefit for Quebecers.

A royalty on water harnessed in Québec

Québec has an abundance of water that provides a significant social and economic advantage. Indeed, 3% of the planet's fresh water is to be found in Québec. The volume of water collected in Québec each year is estimated at 3.5 billion cubic metres.

As part of the government's sustainable development initiative, and so that Quebecers benefit from the use of this tremendous source of collective wealth and use it responsibly, the government will study the possibility of implementing a royalty on water harnessed in Québec.

Before considering implementing this royalty, however, a variety of work, in particular at the legal level, will have to be completed to determine an adequate level of taxation and collection details.

In this regard, it should be noted that most provinces in Canada have passed legislation specifying that water is owned by the state; indeed, some provinces already impose royalties on the harnessing of water. For example, British Columbia currently collects revenues of roughly $6 million per year from such a royalty. If applied in Québec, that would mean revenues of some $11 million.

Expected results

The reduction of the debt burden, thanks to the Generations Fund, will have tangible positive effects on Québec's public finances and economy.

A major debt retirement effort

Even without the amounts that may be provided by assets sales, by part of the earnings derived from foreign sales of electricity from Hydro-Québec's new production capacities or from a royalty on harnessed water, the Generations Fund will enable more than $8 billion of the debt to be retired by 2015-2016. In 2025-2026, i.e. a decade later, nearly $30 billion may be allocated to debt retirement.

TABLE 6

PROJECTION OF AMOUNTS ACCUMULATED IN THE GENERATIONS FUND
(Millions of dollars)

	Water-power royalties		Hydro-Québec electricity exports	Harnessed water	Asset sales	Investment income	Balance as at March 31
	Hydro-Québec[1]	Private producers					
2006-2007	64	9	—	—	—	1	74
2007-2008	325	49	↑	↑	↑	16	464
2008-2009	535	80	↑	↑	↑	53	1 132
2009-2010	546	81	↑	↑	↑	102	1 861
2010-2011	564	83	Impact to be determined			158	2 666
2015-2016	645	91	↓	↓	↓	578	8 173
2020-2021	712	100	↓	↓	↓	1 212	16 764
2025-2026	787	110	↓	↓	↓	2 180	29 877

1 The growth expected until 2011-2012 stems chiefly from the currently stipulated increase in Hydro-Québec's production capacity. Thereafter, the increase is attributable solely to the indexing of water-power royalties already stipulated in the *Watercourses Act*.

Source: Ministère des Finances.

Moreover, it is interesting to note the positive dynamic that the Generations Fund will trigger. The interest accumulated in the Fund will increase. In 2025-2026, this interest alone will contribute roughly $2.2 billion to debt retirement.

This result shows the importance of immediately starting a debt retirement process to benefit as soon as possible from this positive dynamic.

It should be noted that, concerning investment income, the expected rate of return corresponds to the rate of return used in the most recent actuarial valuation of the Government and Public Employees Retirement Plan (RREGOP), i.e. 7.7% per year on average over the next 20 years. This is less than the rate of return of the CDPQ which amounted to 9.4% per year between 1995 and 2005.

25% of GDP by 2025: an ambitious objective that will be achieved

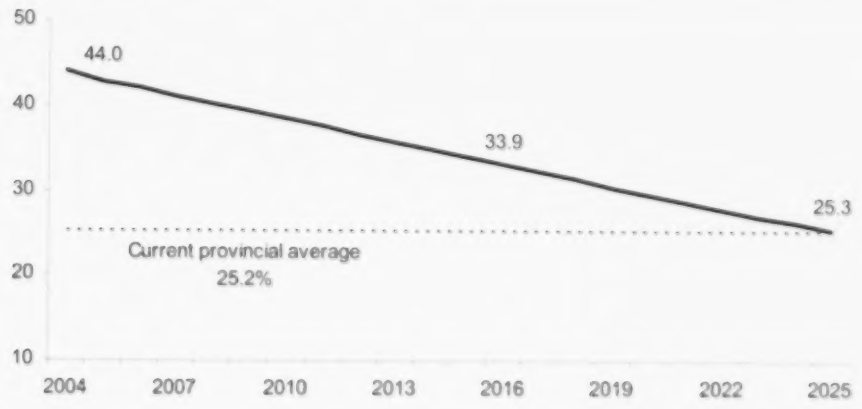
Thanks to the Generations Fund, the burden of the debt in the economy will decrease appreciably and the government's objective of 25% of GDP by 2025 will be achieved.

It should be mentioned that the debt burden would have declined over the coming years as Québec's economy grows. However, to rely solely on economic growth would not be responsible since this growth and public finances can be affected by the aging of the population and the decline of Québec's population.

The Generations Fund will thus accelerate the reduction of the debt burden. Within 20 years, $30 billion will be so allocated. Accordingly, by 2025, Québec will reach the current provincial average in Canada.

CHART 20

PROJECTION OF THE TOTAL DEBT AS A PROPORTION OF QUÉBEC'S ECONOMY
(As a percentage of GDP)



Source: Ministère des Finances.

While the other provinces may also reduce their debt burden over the coming decades, the scope of Québec's action plan is such that substantial ground should be made up.

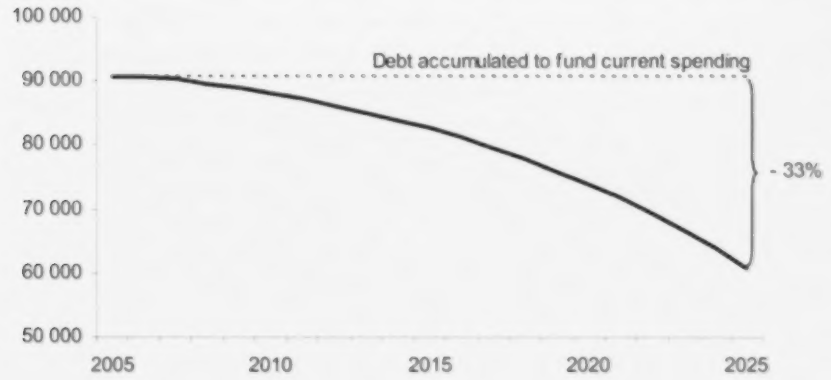
Greater equity toward future generations

The reduction of the debt burden will also foster greater equity toward future generations with the gradual elimination of the debt accumulated to fund current spending.

By 2025, the debt accumulated to fund current spending will be reduced by one third.

CHART 21

REDUCTION IN THE DEBT ACCUMULATED TO FUND CURRENT SPENDING
(Millions of dollars)



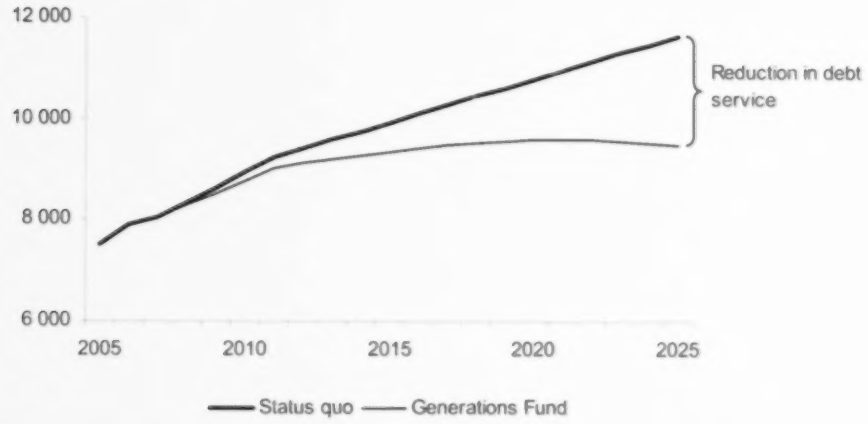
Source: Ministère des Finances.

A reduction in debt service

A major benefit arising from the creation of the Generations Fund will be the option available to the Québec government to improve its financial leeway by using the amounts accumulated in the Generations Fund to retire borrowings that reach maturity. Debt retirement will then entail a substantial reduction in debt service charges.

CHART 22

REDUCTION IN DEBT SERVICE ATTRIBUTABLE TO THE GENERATIONS FUND
(Millions of dollars)



Source: Ministère des Finances.

Accordingly, in 2015, when the effects of the aging of the population will truly begin to emerge, the amounts accumulated in the Generations Fund will allow debt service to be reduced by more than $500 million. This decrease in debt service will become more important as the government faces mounting pressure caused by demography on Québec's public finances.

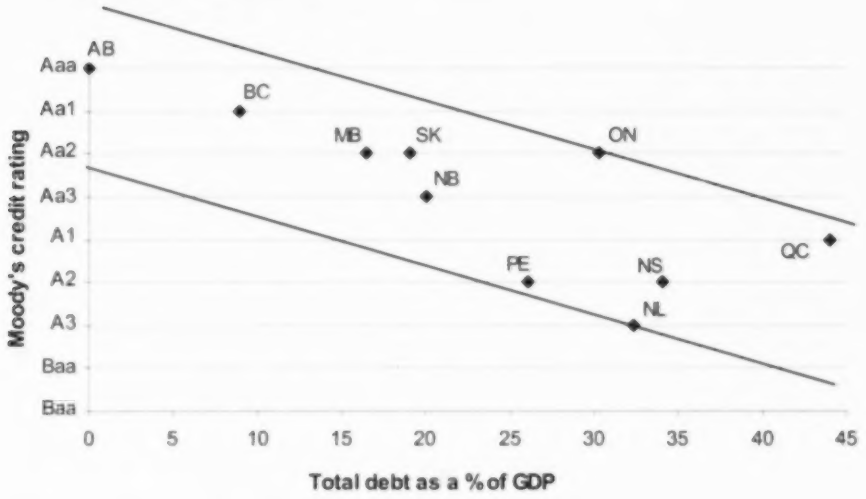
More favourable conditions for an upgrade in Québec's credit rating

Reducing the debt burden will also help set the stage for an upgrade in the Québec government's credit rating.

While many factors come into play to determine the cost of a province's borrowings, there is a close link between the credit rating and the cost of borrowing: the lower the credit rating, the higher the cost of borrowing.

CHART 23

RELATION BETWEEN PROVINCIAL DEBT LOAD AND THE CREDIT RATING, 2005



Sources: Moody's and Ministère des Finances.

A more favourable environment for prosperity

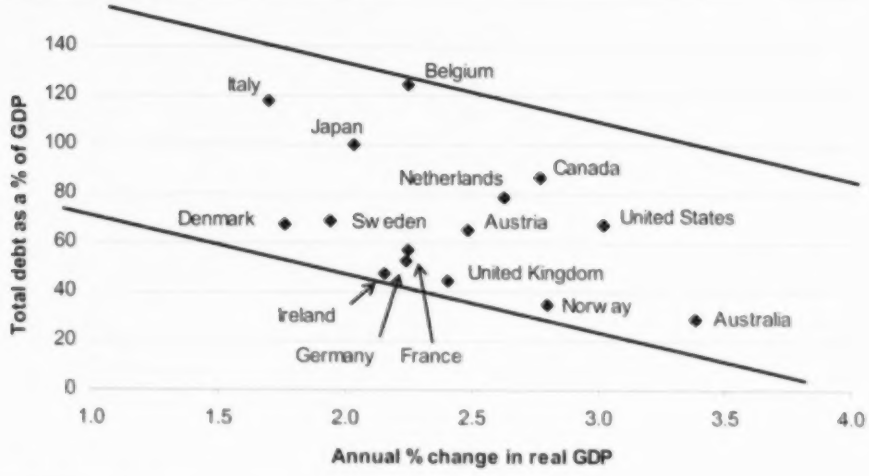
Lastly, debt retirement will also result in major indirect benefits for Québec's economy and Quebecers' standard of living.

Many factors have significant importance on economic activity and the standard of living, like demography, productivity and growth in investment. Debt retirement will reinforce the impact of these factors and thus contribute to creating a favourable environment for economic growth and a rising standard of living.

In this regard, it is worth noting the close link between the debt burden and economic growth. The experience of countries of the Organization for Economic Cooperation and Development (OECD) shows that states with a small public debt have, on average, more vigorous economic growth. Québec should not be an exception to this rule.

CHART 24

ECONOMIC GROWTH AND PUBLIC DEBT
(17 OECD countries – 1988 to 2003)



Source: Organization for Economic Cooperation and Development.

It should also be borne in mind that higher economic growth results in additional tax revenues for the government. An increase in economic growth of just 0.2 percentage points would result in additional and recurring tax revenues of $450 million at the end of five years and close to $1 billion per year at the end of ten years.

Conclusion

With the implementation of the Generations Fund, the government has taken another crucial step in restoring order to public finances and improving equity toward future generations.

This unprecedented initiative is indicative of the government's determination to preserve, for the future, the level and quality of the public services Quebecers value so highly.

It is also the starting point for a broader examination of the dynamic of Québec's public finances.

Lastly, this initiative reflects the need to act now. To delay would not be responsible. Tomorrow, the solutions will impose themselves and could have dramatic consequences on Québec's tax competitiveness, public services and, unquestionably, Québec's prosperity and Quebecers standard of living.

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